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TAGS: EFIN ECON TU
SUBJECT: TURKEY: IMF DEAL LIKELY BUT TIMING UNCERTAIN

REF: A. ANKARA 68
¶B. 2008 ANKARA 1982
¶C. 2008 ANKARA 1978
¶D. 2008 ANKARA 1744
¶E. 2008 ANKARA 1228

Classified By: Econ Counselor Dale Eppler for reasons 1.4 (b,d)

¶1. (C) Summary. IMF negotiators told G-7 Ambassadors January 15 that they expect to reach agreement with the GOT on a new stand-by arrangement (SBA), but the timing of a deal is uncertain. The Fund projects negative growth in 2009, while the GOT is insisting on a low but positive growth figure. The size and duration of the SBA have not been negotiated, but it would be "large" and the Fund would like it to extend through two full budget cycles. The program would be "conditionality lite," with the Fund asking for adoption of a fiscal rule, reduction of the informal economy, increased auditing, and municipal finance reforms. The Fund is studying the 2009 budget and additional spending cuts may be needed, but the Fund opposes cuts to investments. The program would focus on ensuring liquidity to cover an expected financing gap, mainly from private sector FX debt payments, with some of the money shoring up the Central Bank's reserves. The GOT has built high investor expectations that an agreement will be signed in January, but it is possible that the IMF team will leave without an agreement this month to do further studies or analysis. This will have to be handled carefully to avoid a sharply negative market reaction. End summary.

¶2. (SBU) IMF representatives, led by IMF Turkey Desk Chief Rachel Van Elkan, briefed G-7 ambassadors on January 15 about the state of the Fund's talks with the GOT. Van Elkan was accompanied by IMF Resident Representative Hosein Samei and Deputy Resident Representative Davide Lombardo. Negotiations are ongoing, but there are many issues that need to be ironed out, and the team has extended its stay until January 24.

The Good News

¶3. (SBU) Van Elkan was more positive about the Turkish economy than during her October 2008 visit, although she still expects a recession in 2009. She pointed to some positive data:

-- Inflation is down and should stay down this year. On January 15, the Monetary Policy Committee of the CBRT cut benchmark interest rates an additional 200 basis points.

-- The current account deficit also is down, due both to the drop in oil prices and a sharp drop in imports. The Balance of Payments in November 2008 improved by a dramatic $2 billion year on year.

-- The Turkish banking sector is in much better condition

than in most emerging markets. Regulations prevented Turkish banks from buying asset-backed securities, so they do not have to deal with impared assets. Turkey has a high capital adequacy requirement of 12%, but Turkish banks on average are maintaining a 16% ratio, double the 8% Basel standard. In stress testing, the Central Bank has calculated that non-performing loans would have to increase to 15% before the banks' capital adequacy would fall below 8%. However, Van Elkan noted that it is inevitable that corporate sector problems will come home to roost in the banking sector. Although there is liquidity in the banks, they are scaling back on lending to any but their best customers and many banks are contracting their balance sheets.

-- The GOT successfully floated a $1 billion eurobond this week with a reduced spread, indicating that capital markets are not closed to Turkey. However, Van Elkan noted that Turkish banks bought 70% of the issue.

Focus on Private Sector Debt

¶4. (C) The Turkish private sector is facing a sharp slowdown in export and domestic demand and difficult financing conditions. There is a private sector foreign currency debt repayment hump in 2009, up to $130 billion by World Bank estimates. While credit markets are open to some extent, it is not clear how successful Turkish companies will be at rolling over this debt. The IMF suspects that much of this borrowing is secured by assets or deposits offshore, but there is not enough data to determine if there is a debt/asset mismatch. It also is unclear whether companies

are willing to draw down foreign assets to repay their obligations. (see Refs B and C.) Accordingly, the IMF expects a financing gap that will need to be filled. If an IMF deal is not signed, the IMF expects slower growth and large FX rate depreciation to finance the gap.

Details Still Need to Be Resolved

¶5. (C) Van Elkan said the deal would be "conditionality light." There is agreement on goals and objectives, but the Fund generally is asking the GOT to come up with ways to meet them that will be politically acceptable, particularly regarding any spending cuts. However, the Fund wants: 1) adoption of a fiscal rule; 2) implementation of tax reform to reduce the informal economy; 3) increased revenue collection through enhancing the Revenue Administration's auditing capacity. The OECD standard is that 30% of tax staff are focused on audits, while in Turkey the number is only 5%; and 4) The IMF also wants to see local government reform that would allow local governments to increase their revenue-generating capacities while tightening their accounting (Note: the GOT discovered late in 2008 that some municipalities were running up large deficits, totaling nearly 0.5% of GDP, much of it in the form of unpaid supplier contracts, while reporting balanced budgets. End note.)

¶6. (C) The Fund and the GOT have not yet agreed on the macroeconomic assumptions that underly the Agreement, in particular, on the GDP assumptions. The Fund expects 1% GDP growth in 2008 following a sharp slowdown in the fourth quarter, and projects negative growth in 2009 (Van Elkan declined to provide exact numbers). Cyclical businesses, such as automotive and durable goods, are in particularly bad shape. Capacity utilization is at an 18-year low and producers have built up substantial inventories. Even if a recovery comes sooner than expected, it will take some time to clear out the stockpiled goods and restart production. Globally, the IMF is predicting a recession in 2009, with conditions improving in 2010. The GOT, however, is insisting on "a low but positive growth figure" (again unspecified) in 2009, based on "unrealistic" expectations of a sharp upturn in the fourth quarter. Van Elkan noted that this may require more study.

¶7. (C) The size and length of the program also are not defined. Van Elkan said they have not yet discussed the size of the program with the GOT because that depends in part on GDP assumptions and the calculation of the funding gap. Because some of the conditionality will require legislation, they want the program to run for two full budget cycles, meaning it would run at least through 2010.

¶8. (C) The Fund team is still analyzing the 2009 budget, particularly in light of its changing growth assumptions. The Fund may ask for a revised budget, but it is not an absolute requirement even if additional budget cuts are needed. They are more interested in getting realistic revenue projections and quality spending cuts. The Fund opposes cuts in investments, and is examining the quality of the cuts made when the budget was passed (ref A). Particularly in the current environment, public investment spending may be the right policy. The Fund also needs more information on proposed programs to provide unemployment benefits to workers who are temporarily laid off. The IMF team is not interested in micro management and noted that it is in Turkey's interests to manage its own fiscal policy. Instead, via the fiscal rule and other medium term policies, it wants to lay the groundwork for a fiscally sustainable budgets as Turkey comes out of recession.

¶9. (C) Van Elkan noted the GOT has boxed itself in on the timing of a new program. Statements by GOT officials have given the strong impression that a new agreement would be signed in January, and markets have priced in an agreement of about $20 billion. However, it is possible that the team will leave Turkey without a deal. This would not necesarily indicate a failure of negotations. It is possible that additional analysis or work may be needed by either or both sides. Even if a deal is signed in January, the earliest it could go to the IMF board would be late February if it was on an expedited schedule, but more realistically it would be taken up in March.

Getting Money to the Private Sector

¶11. (C) An area of key interest is how IMF money will get to the private sector where it is needed. The two major options are via the Central Bank (CBRT), onlending to the banking sector, or via the Treasury, where more active government programs could be used. Van Elkan said it was likely that the IMF would lend to the Treasury, as it has in past programs. The CBRT wants to maintain its independence and focus on minimizing inflation, and is uncomfortable running other programs. The Treasury Ministry will maintain the money in accounts at the CBRT and the Fund will put limits on the speed and amount of drawdowns. One likely option will be for the Treasury to use some of the money to buy up GOT securities from the banking sector, which would free up additional money for lending. This will allow banks to make credit decisions on who should receive funding, something that neither the IMF nor the GOT is equipped to do. Resident Rep Samei said that Treasury Minister Simsek understands this and is disinclined to pursue direct GOT lending programs. Van Elkan added that some of the IMF money is likely to go to the CBRT to shore up its reserves.

¶12. (C) Comment: Negotiations continue and there is a clear inclination on the part of the Fund to reach an agreement, but there also was no sense of urgency to do so. The most worrisome part of the briefing was Van Elkan's comment that the Fund team could leave this month without an agreement. While there may well be good and valid reasons why they cannot sign an agreement this month, markets are not prepared for that eventuality. It would be advisable in that situation for the GOT and the Fund to issue a joint statement on the status of the talks to avoid a sharply negative market reaction to what the GOT has billed as a done deal.

Jeffrey